

June 21, 1948

Z-2294

Chairmen of the Federal Reserve Banks.

Some reports from press and other sources have given the erroneous impression that the Board's recent action increasing reserve requirements at New York and Chicago was intended as a slap at the Treasury or to take advantage of the absence of Chairman McCabe due to illness. Since such reports misinterpret the reasons for the Board's action, this letter is being sent to you in order that you may have the facts for your information and that of your board of directors. It is not intended, however, for circulation or for publication.

You know, of course, that this raise in reserve requirements was the second in a series of three steps, the first of which was taken last January and became effective in February. It simply tends to restore the relationship which the law contemplates between central reserve, reserve, and other cities, namely, the maximum of 26, 20, and 14 per cent on demand deposits which had existed in 1942. It was not an action taken hastily but on the contrary only after repeated consideration. It had a background of careful study and discussion before the first step was taken as well as during several intervening meetings since then. While Chairman McCabe was at some of these meetings, there were others which he could not attend. As a result there were several postponements of the final determination of the question. When the action was taken, although Chairman McCabe was absent on account of illness, the other members of the Board had the benefit of his views, and he did not request further postponement.

Time had been running short because it had become apparent that the effective date must be prior to the June tax payment and the July 1st refunding, or that it should be postponed until sometime in July or August, or until after the September financing. In the final discussion the question became one solely of timing. The postponements which had already taken place left less than two weeks for notice of the Board's action to become effective at the end of the last reserve calculation period before the June payments.

One of the factors entering into the decision was that if the support levels on Treasury certificates were to be dropped in July or August in preparation for a raise in the certificate rate in September to $1\frac{1}{4}$ per cent, it would be difficult to justify a concurrent raise in reserve requirements. In other words, having sold banks the $1\frac{1}{8}$ per cent certificates in July, it would not seem fair then to apply the pressure of increased reserve requirements on top of a drop in the support levels, if decided upon, as the banks might have to sell their certificates in order to meet the increased requirements. The step which has been taken was for the purpose of applying some pressure now, and the dropping in support levels later would be for the purpose of continuing the pressure over the summer months; thus the timing of the third step in raising reserve requirements could follow in the fall. Otherwise, the raise in reserve requirements could be made in July or August, if the short-term certificate rate were not permitted to rise. From what has been said it will be seen that the possibility of a further 2 per cent increase in reserve requirements after the first step, which became

effective in February, was in contemplation long before the Treasury decided against a rate increase for the June refunding. While the Board as well as the Open Market Committee had hoped that the Treasury would make the increase proposed in the rate from 1-1/8 to 1-1/4 per cent, and they were disappointed, that decision was one which was recognized as being within the province of the Treasury. The Treasury equally recognized that it was within the province of the Board to raise reserve requirements at New York and Chicago if it felt warranted in doing so. The Treasury has the responsibility for the cost of Government financing while the Board has the responsibility for such anti-inflationary steps as lie within its powers. The step actually taken was relatively mild.

In this connection, it will be recalled that the Federal Advisory Council, the membership of which includes representatives of New York and Chicago, one of whom is President of the Council, unanimously opposed the Board's proposals for increased power over reserve requirements, on the ground, among others, that the Board "still has the power to raise reserve requirements in central reserve cities and so tighten money" which it had not used. The Board had already used the full extent of its powers in reserve and nonreserve cities and recognized the difficulty of convincing many people of the need for additional power when it had not used fully the pattern laid down by law for the principal money markets, New York and Chicago. Therefore the Board felt that it could properly go ahead within its remaining responsibilities even though the Treasury had not, in its discretion, seen fit to raise the certificate rate.

The fundamentals of the inflationary picture have not altered and there is no indication of a decline in the trend. It is generally accepted by the banking fraternity that the inflationary trend warrants an increase in the short-term rate. In the absence of action by the Treasury in this regard, a raise in the reserve requirements might also have some anti-inflationary influence when taken as precautionary or preventive medicine, and would have less value as the disease advanced.

These were the views of a majority of the Board members, who were pressing for action and, as will be seen from the foregoing brief resume, the action was neither hasty nor inadequately considered, nor was it taken without full discussion of and due regard for any differing viewpoints. It should be clear that, contrary to such interpretations as have emanated from press and other sources, it was not a slap at the Treasury, nor was there any design to take advantage of Chairman McCabe's absence. The views of all of the Board members were canvassed before the final determination of the question.

Very truly yours,

S. R. Carpenter,
Secretary.